

Resource

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## Key decisions

### Division of ownership and protections

Founders become the first stockholders (*i.e.*, owners) of a company when granted stock at the time of incorporation.

*Percentage ownership:* How much of the company will each founder own? Carefully consider each founder's pre-incorporation role and anticipated roles and responsibilities going forward. Once the company's stock begins to appreciate in value, transfers among founders to correct imbalances or otherwise adjust ownership may result in unintended tax consequences.

*Vesting:* Generally, subjecting a founder's stock to vesting requires that founder to remain in service with the company for a certain period of time before fully owning the stock. The company has a right to repurchase unvested shares at cost should the founder decide to leave the company during the vesting period, preventing a "windfall" of vested stock (and corresponding voting control). A company's first investors typically require vesting to ensure the founders have adequate incentive to stay with the company and continue to contribute to its success.

*Termination without cause:* Founders can add protections such as vesting acceleration if terminated without cause or if terminated in connection with a change in control.

Your Gunderson team can advise on founder matters and provide impartial guidance on preparing for the issues and conflicts that sometimes arise among founders.

## Preparing for employees

Founders will need to forecast staffing needs as the company begins operations. It is important that an employer establish a reliable payroll system to, among other things, ensure that withholding and other tax matters are handled properly. Compliance with federal, state and local employee protection laws and regulations is mandatory. As a start, this includes:

- observing laws regarding job postings, interviews, background searches, salary transparency, offer letter terms, and the use of AI in hiring and managing the workforce
- correctly classifying workers as employees or independent contractors
- correctly classifying employees as exempt or non-exempt
- paying employees a minimum wage or salary (including to the founders)
- structuring and documenting commission plans correctly
- establishing workplace policies and an internal reporting system for instances of harassment and discrimination

Consult with your Gunderson team if you plan to expand your business operations outside of the United States, engage with non-U.S. service providers (including consultants), or enter into any related contract.

## Type of equity - stock or options (or both)?

Founders typically receive shares of common stock at the time a company is incorporated, when the stock has minimal value. A company may continue to issue common stock to its early employees and other service providers while the value of the stock is low. Once the stock price rises and a purchase of stock (or the payment of tax on its value) becomes too expensive or too risky of an investment for service providers generally, companies typically switch to granting stock options.

Stock options are a type of equity compensation award that provides the holder with the right to purchase (*i.e.*, “exercise”) a specified number of shares of common stock at a fixed price. Stock options generally provide the service provider choice and flexibility in deciding if and when to invest, but also require a basic knowledge of various stock option terms and tax implications upon exercise and when the shares are sold.

Equity awards are often an integral part of an employee’s overall compensation package in the technology start-up space. Equity-based compensation gives employees an opportunity to invest in the company and become stockholders, and potentially benefit from any increase in the stock’s value if the company is acquired or goes public.

## Equity terms

*Vesting:* Companies in the technology space typically grant employees equity that vests over four years. 25% of the shares (or the shares underlying an option) vest after the employee has completed one year of service, with the remainder vesting in equal monthly installments over the next three years.

*Vesting acceleration:* A company may grant a service provider equity with vesting acceleration, meaning that, upon the occurrence of certain events, up to all of the unvested shares (if any) are deemed vested and no longer subject to the company’s right of repurchase. Vesting acceleration is a term typically reserved for executives, key employees and board members. “Single-trigger” requires only one event to occur (e.g., a change in control or a termination without cause) for vesting to accelerate. “Double-trigger” means that two events must occur (typically a termination without cause in connection with a change in control) to trigger the vesting acceleration.

*Other:* Founders may consider non-standard vesting schedules, option exercisability, and what types of equity may potentially provide certain tax benefits to employees.

What types of equity and what terms will best incentivize your employees? Your Gunderson team can advise on equity matters and importantly, the standard terms potential investors often favor when considering an investment.

## Transfer restrictions

In what circumstances may stockholders sell or transfer shares? Founders often consider establishing transfer restrictions at the time of incorporation so that stock is not transferred or sold without the company's consent except in certain circumstances (e.g., estate planning, certain gifts, transfer among affiliates).

## Potential pitfalls

Be aware of common mistakes founders and executives often make when hiring employees and issuing (and receiving) equity. In some instances, mistakes can deter potential investors and jeopardize fundraising efforts.

- Postponing the issuance of founder stock

*Issue founder stock as early as possible. A founder may owe taxes or have to pay for shares out-of-pocket if stock is issued once it has value (e.g., after the company has received a financing term sheet).*

- Neglecting to file a Section 83(b) election for stock “subject to a substantial risk of forfeiture” (i.e., unvested stock)

***Filing a Section 83(b) election potentially minimizes a stockholder's future tax liability.*** A stockholder filing this tax form “elects” to pre-pay taxes based on the stock's value on the date it was granted, rather than as it vests.

- Missing the deadline to file a Section 83(b) election

***A Section 83(b) election must be filed within 30 days of stock grant or option exercise – no exceptions!***

- Failing to comply with laws governing employee classification and compensation

*See **preparing for employees** above.*

- Issuing unfamiliar equity-based compensation (e.g., restricted stock units, phantom stock, profit interests)

*Consider time and cost to implement and maintain (including employee education); complex types of equity may carry unexpected tax consequences; potential investors may question non-standard equity-based compensation programs and require changes going forward.*

- Entering into service agreements offering company equity without legal counsel review

*Consult with your Gunderson team before signing agreements (e.g., with recruiters, educational institutions, accelerators) that offer company stock, options or warrants as consideration for services. Your Gunderson team can advise on the requirements for granting equity and the types of equity best suited for these service providers.*

- Over-complicating vesting schedules

*Generally reserve “customized” vesting schedules (including performance-based vesting) for executives and key employees.*

- Failing to grant equity-based compensation, including stock options, correctly

*See **establish best practices** below. Promising equity in an agreement or offer letter is not enough!*

- Advising employees on whether and when to exercise stock options

*The decision to exercise a stock option is personal and carries investment risk; company management should stay neutral.*

- Basing decisions on “what other companies are doing” or current trends

*What will best incentivize your company’s employees?*

## Establish best practices

### Classify service providers correctly

Your Gunderson team can assist in the analysis of determining whether service providers are employees or independent contractors (regardless of job title or agreement between the parties), and if employees are exempt or non-exempt from overtime pay. Misclassification can be costly if the employer is required to pay back wages and penalties, and in some instances may result in civil and criminal penalties.

### Consider hiring a Human Resources specialist

Federal and state employment laws seem to change on a daily basis and are becoming increasingly complex. Consider hiring a Human Resources specialist early on to, among many other things, (i) handle employee matters such as offer letters and workplace notices, (ii) create employee handbooks that include required

discrimination and harassment policies and procedures, and (iii) monitor changes in federal, state and local employment law and assist company management in maintaining compliance with such laws as applicable. Gunderson's Employment and Labor Group is available to provide manager and employee training.

## Follow recommended protocol when issuing stock options

- Generally, a company's board of directors grants stock options and approves related terms, including vesting schedule, type of option and exercisability in addition to recipient name and number of shares.

*(Informal approval or undocumented terms may be questioned during the due diligence process.)*

- Options are only "promised" until formally granted by the board of directors.

*(Options are not granted by a company in offer letters, service agreements or other communications.)*

- Keep track of "promised" stock options and maintain a regular schedule for granting options.

*(Stock options can only be granted to current service providers and inadvertent omissions may be difficult to remedy post-termination of service.)*

- Be aware of share limitations.

*(Share limits include (i) the number of shares of common stock authorized for issuance in the company's certificate of incorporation and (ii) the maximum number of shares reserved for issuance under a company's stock plan.)*

- In most cases, stock options can only be granted to individuals and not entities.

*(There are often alternatives; your Gunderson team can advise.)*

- Due to legal and tax restrictions, a stock option's exercise price may not be less than the fair market value per share of the underlying common stock on the date the option is granted.

*(If a company's stock is not publicly tradable, the company's board of directors determines fair market value on the date the option is granted, typically in reliance on an independent report, commonly referred to as a "409A valuation".)*



- Notify your Gunderson team if you are preparing to fundraise or are expecting a term sheet.

*(A material event such as a priced financing round may invalidate a 409A valuation. Without a valid 409A valuation, the board may inadvertently grant options with an exercise price less than current fair market value.)*

## Maintain the company's capitalization table (spreadsheet or online platform)

Capitalization – the equity ownership of a company – is a key diligence matter and investors will closely examine if equity was properly approved, if paperwork and stock/option ledgers are accurate, how fair market value was determined, and if vesting schedules and other key terms comport with market standards.

## Educate yourself and your employees

Your Gunderson team can point you to resources for employers and assist you in learning more about stock and stock options, and the tax treatment of the various types of equity. Take the time to read through the company's stock plan and form documents. As your company grows, consider setting up an education session for your employees with a member of Gunderson's executive compensation group.

## As a founder, seek advice from a personal financial or tax advisor

Do not wait until the company is about to be acquired! An advisor can help with tax planning and other matters related to a founder's stock and options from the start, including QSBS (Qualified Small Business Stock) requirements and maintaining eligibility for certain tax benefits at the time the stock is sold.

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### RESOURCE

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### INSIGHTS

Ryan Purcell Guest-Authors “6 Startup Mistakes That Cost Founders Everything (And How to Avoid Them)” for Not Another CEO



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